

ICPS newsletter

Generic approach is needed for reforming natural monopolies

Privatisation and liberalisation are underway in those sectors of the Ukrainian economy where natural monopolies exist. However, general vision and policy principles regarding natural monopolies are yet to be developed. In order to elaborate a general approach to reforming natural monopolies, and to define sectoral priorities in this process. The International Centre for Policy Studies held an expert discussion titled "Policy for reforming natural monopolies in Ukraine". The discussion also intended to facilitate the development of a special chapter for ICPS's journal Quarterly Predictions

What is natural monopoly?

In certain sectors of the economy, only a sole company can be an efficient producer of goods or services. If average costs increase when competitors enter the market, the sector is a *natural monopoly*. The following services are currently designated as natural monopolies in Ukraine: gas and electricity transportation, local telephony, rail road, heat and water supply. Diminishing average costs is the common feature of these industries: high initial costs to ensure service provision (for example, installing power or phone lines) are followed by fixed, or even diminishing, costs needed to serve every additional consumer. The existence of natural monopoly companies in certain sectors is desirable for society as they are more efficient than competition.

The activity of natural monopolies is not different from the behaviour of ordinary monopolies and therefore inevitably leads to losses for the public. Monopolists tend to maximise their own profits, not public wellbeing. As a result, there is a need to regulate the activity of natural monopolies in order to achieve a win-win situation—the natural monopoly providing services with minimal costs, while the society is able to avoid losses which result from the monopolistic behaviour of the producer.

How are natural monopolies regulated?

Regulatory policy on natural monopolies has the following objectives:

- ensure a net profit from regulation (costs

of regulation should not exceed the losses of the natural monopoly);

- decrease public losses caused by distorted pricing and resource distribution;
- guarantee smooth functioning of sectors which are natural monopolies and ensure that services are available;
- create incentives for innovative activities.

The government usually regulates the rates which natural monopolies impose on provided monopoly services, as well as the access of consumers to such services. International experience demonstrates that an independent regulatory body ensures the most efficient regulatory activities in this sphere. The Law of Ukraine "On natural monopolies" regulates the creation of such bodies for natural monopoly sectors.

Soviet legacy complicates the situation

A special feature of natural monopolies in Ukraine is that the majority of monopolies are state enterprises which work both in naturally monopolistic and potentially competitive markets. For this reason, the first step towards reforming natural monopolies should be to restructure enterprises with corporatisation and spin-off of "non-monopolistic" sub-divisions. "Non-monopolistic" markets should be liberalised, while "non-monopolistic" enterprises should be privatised.

Eventually, regulations should be implemented (relevant laws and normative acts should be adopted, an independent regulatory body should be established), and

the issue regarding optimal ownership for natural monopolies should be addressed.

Choosing the form of ownership

The benefits of privatisation embody the notion that a private company has all the incentives for effective functioning and for engaging in active innovative activities, give a favourable regulatory environment. However, the costs of regulation are high (elaboration of pricing methodology, development of standards, monitoring and control, etc.).

The benefit of state ownership is that the state enterprise is managed by the principle of maximisation not of profits but public wellbeing, and part of the monopoly revenue is distributed in favour of consumers. Among the drawbacks are lower efficiency of state enterprises comparatively to private companies where business activities are determined by different incentives. Furthermore, the meaning of "public wellbeing" depends on the current political situation. Unlike the managers of private firms, directors of state enterprises have lower incentives to satisfy owner interests. Compared to private firms, state enterprises are managed less efficiently, since state controllers have lower labour incentives. Since clear control procedures are missing, managers of state enterprises often tend to abuse.

Concession is a third possible form of ownership; in this case, the government sells the right to manage the monopoly to the private agent proposing the lowest price for service delivery and satisfying certain requirements (which should replace regulation). The advantages of concession are that the contract partially replaces regulation (therefore, there is no need to spend on a permanent regulatory body) and that concessionaires use resources efficiently. The substantial disadvantages of concession agreements are that the price

for services depends on the level of competition at the stage of the concession tender, and weak control which can affect the quality of services.

During the abovementioned discussion, ICPS's experts evaluated the three described options while taking into account the realities of the transitional period in Ukraine. State ownership does not necessarily follow corporate management procedures which comply with the demand of a market economy. However, this option can be optimal when privatisation is associated with high risks. The risks of natural monopoly privatisation in Ukraine include unclear mechanisms for contract enforcement and a weak judicial system. Concession creates big opportunities for corruption, since long-term contracts do not have clear regulatory provisions. In addition, the uninviting investment image of Ukraine does not increase the number of potential contestants to participate in concession tenders.

Experts emphasise common features and differences among industries

The discussion demonstrated that despite technological distinctions in different industries, the problems of regulation for natural monopolies are, in fact, common. In any case, a common principle should be followed: regulations should be developed prior to privatisation. Another common feature for all industries is the need to develop clear mechanisms for price regulation which are based on proven theory. Meanwhile, such aspects as restructuring of enterprises which belong to natural monopolies and choosing an optimal form of ownership for them differ from industry to industry. For instance, the gas transportation system has a monopoly importer for its services—the Russian joint-stock company Gazprom—and technological features which limit the possibilities to split it among several enterprises. In terms of ownership,

privatisation is risky, because for political reasons it will be difficult to follow regulations if Gazprom wins the tender. On the other hand, state ownership would result in permanent pressure to gas transporting enterprises on the part of government bodies whose actions are influenced by politics.

The discussion also revealed that the ongoing process of reform in different natural monopoly industries is inconsistent. Whereas issues regarding the determination of optimal powers of an independent regulatory body have been already raised for the communication and electricity sectors, Ukrzaliznytsia (railway monopoly enterprise) has not even approached the stage of corporatisation and remains under the relevant ministry. These facts show the urgent need to determine the priorities for reforming natural monopolies in Ukraine. ■

The expert discussion "Policy for reforming natural monopolies in Ukraine" took place at the International Centre for Policy Studies on 18 January 2001.

Participation of entrepreneurs in policymaking yields results

On 15 January, a meeting of the Council of the Coordination and Analysis Centre for Ukrainian Business Associations (CEC) took place in order to summarise the results of the CEC's activities in 2000 and to discuss plans for the nearest period

Today, the Coordination and Analysis Centre, in which one of co-founders is the International Centre of Policy Studies, unites several dozen associations, unions, and federations of different missions. At the CEC's initiative, a Council of Ukrainian Business Associations was created under the State Committee for Economic Development on 18 May 2000. The council aims to involve business associations in work on drafting laws related to entrepreneurship, to ensure open decision-making, and to provide feedback between entrepreneurs and executive bodies. According to Yuri Yekhanurov, First Deputy Prime Minister of Ukraine, this consulting and advising body "effectively influences government officials and makes them hear the voice of the public and take into account its interests."

Thanks to the consolidated efforts of the Coordination and Analysis Centre, the Law of Ukraine "On licensing certain economic activities" was adopted. This legislation provides a partial transition from the permissive to the declarative principle of

licensing, facilitates the procedures for obtaining licenses by entrepreneurs, and establishes clear responsibilities for breaching legislation on licensing. CEC experts are continuing to work on licensing by-laws.

As a result of another campaign initiated by the Coordination and Analysis Centre, the law "On using electronic cash registers and sales books in transactions with customers in trade, catering, and the services sector" was amended; under the non-amended law, it was practically impossible to run a business legally for those choosing the simplified taxation system. Initially, as a result of pressure on the part of business associations, the term for the law coming into force was postponed, then the law amendments were lobbied.

CEC's experts also actively participated in drafting a Special Chapter and Chapter 13, "General administrative provisions", of the Tax Code, and the laws "On microloans originated by special organisations for small enterprises", "On standardisation", "On

confirming compliance", and "On accrediting bodies for compliance evaluation".

At the meeting, membership was granted to 14 more business associations. In addition, the Kherson Regional Representative Office of Coordination and Analysis Centre was inaugurated. CEC already has its branch offices in Lviv, Ternopil, Kharkiv, Dniprodzerzhynsk, and Odesa.

Facing the need to be institutionalised, the analytical group of the Coordination and Analysis Centre established the Institute of Competitive Society in June 2000. At the meeting, the CEC Council delegated the functions of the analytical group to this institute.

Members of the Coordination and Analytical Centre also decided on major CEC activities in 2001. In particular, priority activities include taxation policy and improvement of draft Tax Code, small business development, simplification of regulations on entrepreneurial activities, development of competition and of a social safety network, and creation of legislation on non-government organisations. In addition, CEC experts plan to develop proposals regarding the coordination between accounting and tax reporting. ■

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